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No. 15-628

IN THE
Supreme Court of the United States

BASSAM YACOUB SALMAN,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF *AMICUS CURIAE* RICHARD D. FREER IN SUPPORT OF RESPONDENT

SARAH M. SHALF
Counsel of Record
EMORY LAW SCHOOL
SUPREME COURT
ADVOCACY PROGRAM
1301 Clifton Road
Atlanta, GA 30322
(404) 712-4652
sarah.shalf@emory.edu

TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES iii

INTEREST OF *AMICUS CURIAE* 1

SUMMARY OF THE ARGUMENT 2

ARGUMENT 4

I. PROSCRIBING INSIDER TRADING ACCORDS WITH A CENTRAL POLICY UNDERLYING FEDERAL SECURITIES LAWS AND REGULATIONS: ENSURING FAIR MARKETS 4

II. THE ECONOMIC BENEFITS OF STRICTLY PROSCRIBING INSIDER TRADING OUTWEIGH THE COSTS 8

A. It Is Unnecessary To Allow Insider Trading to Promote Pricing Efficiency In United States Capital Markets 9

B. Insider Trading Can Harm Pricing Efficiency Due To A Crowding-Out Effect 11

C. Managers' Ability To Trade On Inside Information Can Incentivize Earnings Manipulation 13

III. A PECUNIARY-GAIN STANDARD WOULD JEOPARDIZE THE SEC'S RECENT PROGRESS IN DETECTING AND DETERRING INSIDER TRADING BY CREATING A LOOPHOLE IN THE INSIDER TRADING LAWS 14

A. Despite Aggressive Government Enforcement Of Rule 10b-5 Over The Last Decade, Insider Trading Remains Prevalent And Difficult To Detect and Deter. 15

B. New Evidence Indicates That Tippers And Tippees Frequently Share Familial Or Social Bonds 17

CONCLUSION 19

TABLE OF AUTHORITIES

CASES

Chiarella v. United States, 445 U.S. 222 (1980) 4

Dirks v. SEC, 463 U.S. 646 (1983) 2, 9

United States v. O'Hagan, 521 U.S. 642 (1997) 4

United States v. Newman, 773 F.3d 438 (2d Cir. 2014) 2

United States v. Kluger, 722 F.3d 549 (3d Cir. 2013) 6

SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005) 7

STATUTES

15 U.S.C. § 78a 3

15 U.S.C. § 78j(b) 4

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 2010 U.S.C.C.A.N. (124 Stat.) 1376 6

Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 1988 U.S.C.C.A.N. (102 Stat.) 4677 6

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OTHER AUTHORITIES

17 C.F.R. § 242.101(c), (f) 7

17 C.F.R. § 243.100 6

Anup Agrawal & Tommy Cooper, *Insider Trading Before Accounting Scandals*, 34 J. Corp. Fin. 169 (2015). 14, 16

Burton G. Malkiel, *A Random Walk Down Wall Street* 246 (9th ed. 2007) 10

Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857 (1983) 9

Diane Del Guercio et al., *The Deterrence Effect of SEC Enforcement Intensity on Illegal Insider*

Trading: Evidence from Run-up before News Events (October 5, 2015) 17

Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. Corp. L. 1 (forthcoming fall 2016) 7

George W Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 Del. J. Corp. L. 247 (2013) 11

Henry G. Manne, Insider Trading and the Stock Market (1966) 9

Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark*, 31 J. Corp. L. 167 (2005). 10, 12

Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 Wm. & Mary Bus. L. Rev. 159 (2014) 6

Ji-Chai Lin & Michael S. Rozeff, *The Speed of Adjustment of Prices to Private Information: Empirical Tests*, 18 J. FIN. RES. 143 (1995) 10

Kenneth R. Ahern, *Information Networks: Evidence from Illegal Insider Trading Tips*, J. Fin. Econ. (forthcoming 2016)..... 18

Laura N. Beny & H. Nejat Seyhun, *Has Insider Trading Become More Rampant in the United States? Evidence from Takeovers* (U. Mich. Law

Sch. Scholarship Repository Working Paper No. 50, 2012) 16

Laura N. Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. Corp. L. 237 (2007) 11

Nuno Fernandes & Miguel A. Ferreira, *Insider Trading Laws and Stock Price Informativeness*, 22 Rev. Fin. Studs. 1845 (2009) 12, 13

Patrick Augustin et al., *Informed Options Trading Prior to M&A Announcements: Insider Trading?* (October 26, 2015) 16

Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs*, 100 VA. L. REV. 313 (2014) 8

Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. Rev. 1589 (1999) 15, 16

Sugato Chakravarty & John J. McConnell, *Does Insider Trading Really Move Stock Prices?*, 34 J. Fin. & Quantitative Analysis 191 (1999) 10

INTEREST OF *AMICUS CURIAE*[1]

Amicus is the Robert Howell Hall Professor of Law at the Emory University School of Law, and specializes in the fields of civil procedure, complex litigation, and business associations. Amicus teaches a course on business associations that covers the topic of insider trading, and is co-author of the course textbook, in addition to other scholarly publications on corporations and other business organizations. Amicus has no personal stake in the outcome of this case, but has an interest in seeing that the law of insider trading develops in a way that promotes fair and efficient markets.

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[1] Pursuant to Rule 37.6 *amicus curiae* affirms that no counsel for a party authored this brief in whole or in part, that no counsel or a party made a monetary contribution intended to the preparation or submission of this brief, and no person other than *amicus curiae* or his counsel made a monetary contribution to its preparation or submission.

Respondent's letter consenting to the filing of this amicus brief, as well as Petitioner's letter granting blanket consent to the filing of *amicus curiae* briefs, are on file with the Clerk.

SUMMARY OF THE ARGUMENT

Petitioner advocates a radical departure from this Court's precedent and the weight of lower-court case law. He claims that the Ninth Circuit's decision in the case below turns the personal benefit test, announced in *Dirks v. SEC*, 463 U.S. 646 (1983), into a "nullity," Pet'r's Br. 16, and urges this Court to adopt the Second Circuit's holding in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015). Petitioner's arguments are unpersuasive. The decision below accords with a plain reading of *Dirks*. In contrast, the *Newman* decision contradicts *Dirks* and undermines important policy objectives embodied in the federal securities laws.

The tension between the decision below and *Newman* arises because the Second Circuit held that, to satisfy the personal benefit test, the government must provide evidence of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." *Newman*, 773 F.3d at 452. Petitioner interprets this language to mean that an inference of personal benefit is only appropriate "where an insider provides a tip in exchange for a pecuniary gain." Pet'r's Br. 19. Yet, as the Ninth Circuit panel recognized in the case below, the pecuniary-gain standard proposed by Petitioner is incompatible with *Dirks*, which clearly stated that gratuitous tips

between relatives or friends can satisfy the personal benefit test.

There are compelling policy reasons for affirming the decision below and rejecting *Newman*'s restrictive interpretation of the personal benefit test. Proscribing insider trading is consistent with the congressional purpose underlying the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78a *et seq.* (2012), which is to protect investor confidence in financial markets by prohibiting fraud in connection with the sale or purchase of securities. The *Newman* decision, if endorsed by this Court, would create a troubling loophole in the insider trading laws: unscrupulous tippers could avoid sanction by simply refusing any tangible, pecuniary benefit in exchange for providing the tip. If adopted, this standard would compromise the government's ability to prosecute insider trading. Such a result is anathema to Section 10(b), the key statutory provision of the Exchange Act.

Recent empirical studies counsel against restricting the scope of the insider trading prohibition. These studies undermine the market-efficiency justification for permitting insider trading. What's more, research indicates that, despite recent success by the SEC in deterring insider trading and enforcing the laws that prohibit it, the practice is quite prevalent—especially among individuals with close familial and social ties. Accordingly, it would be counterproductive for this Court to adopt the *Newman*

court's narrow interpretation of the personal benefit test. •

ARGUMENT

I. PROSCRIBING INSIDER TRADING ACCORDS WITH A CENTRAL POLICY UNDERLYING FEDERAL SECURITIES LAWS AND REGULATIONS: ENSURING FAIR MARKETS

In *United States v. O'Hagan*, this Court declared that an "animating purpose" of the Exchange Act is "to insure honest securities markets and thereby promote investor confidence." 521 U.S. 642, 658 (1997). The key statutory provision of the Exchange Act is Section 10(b), 15 U.S.C. § 78j(b) (2012),[2] which is "aptly described as a catchall [fraud] provision." *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980). Its text makes clear that the enacting Congress intended for the SEC to promulgate rules

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[2] The relevant language from that provision states: "It shall be unlawful for any person to use or employ, in connection with the purchase or sale of any security any manipulative or deceptive device in contravention of such rules and regulations as the Commission may prescribe as necessary for the protection of investors." 15 U.S.C. § 78j(b) (2012).

and regulations that would help effectuate the aim of the law. Resp't's Br. 14.

Extending the prohibition on insider trading to gratuitous tipping is logical and necessary to effectuate the animating purpose of the Exchange Act. Adopting a pecuniary-gain standard, as Petitioner and his amici urge, would allow unscrupulous market participants to circumvent Rule 10b-5. A tipper could avoid criminal liability by simply refusing all forms of tangible compensation in exchange for the confidential information she provides; likewise, a tippee could keep herself out of jail by not providing the tipper with a pecuniary benefit (*i.e.*, money or other tangible assets). Whether it is a tipper or tippee who reaps illicit gains from insider trading, the harm to market integrity and investor confidence is the same: if ordinary investors perceive that corporate insiders or analysts can trade on nonpublic, material information with impunity, they will be reluctant to invest their money in the stock market.

Post-Exchange Act legislation makes clear that Congress intends to strictly curtail insider trading. Resp't's Br. 30. For instance, Congress passed laws in 1984 and 1988 seeking to deter insider trading by increasing penalties for insider trading violations and providing the SEC with more investigative authority. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 1984 U.S.C.C.A.N. (98 Stat.) 1264 (codified in scattered sections of 15 U.S.C.); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No.

100-704, 1988 U.S.C.C.A.N. (102 Stat.) 4677 (codified in scattered sections of 15 U.S.C.).

More recent legislative enactments indicate that Congress's view on insider trading has not changed. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 2010 U.S.C.C.A.N. (124 Stat.) 1376, clearly evinces Congress's position that insider trading should be broadly prohibited. *See, e.g., United States v. Kluger*, 722 F.3d 549, 556 n.11 (3d Cir. 2013) (noting that the Dodd-Frank "guideline sentencing range increase [for organized insider trading schemes] reflects a continued push to ratchet up the penalties for insider trading"). Perhaps most tellingly, four years ago Congress passed the Stop Trading on Congressional Knowledge Act (STOCK Act), Pub. L. No. 112-105, 2012 U.S.C.C.A.N. (126 Stat.) 291, which explicitly prohibits members of Congress from exploiting nonpublic, material information for their personal benefit. Resp't's Br. 30; *See* Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 Wm. & Mary Bus. L. Rev. 159, 165 (2014) ("The preamble of the STOCK Act states that its purpose is 'to prohibit Members of Congress and employees of Congress from using nonpublic information derived from their official positions for personal benefit, and for other purposes.'") (citation omitted).

Finally, the 2002 enactment of Regulation FD ("Fair Disclosure"), 17 C.F.R. §§ 243.100, 242.101(c), (f) (2011), also weighs heavily against adopting the Second Circuit's *Newman* decision. Resp't's Br. 53–54.

Generally, "Regulation FD prohibits a company and its senior officials from privately disclosing any material nonpublic information regarding the company or its securities to certain persons such as analysts and institutional investors." *SEC v. Siebel Sys., Inc.*, 384 F. Supp. 2d 694, 696 (S.D.N.Y. 2005). A forthcoming article by Professor Donna M. Nagy, a securities law scholar, discusses how the passage of Regulation FD undermines any argument that gratuitous tipping should be permitted: "[A]gainst the backdrop of Regulation FD, it now makes little sense to narrowly interpret the personal benefit element to facilitate what *Dirks* had viewed as the analyst's role in 'ferret[ing] out material nonpublic information from an issuer's officials.'" Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. Corp. L. 1, 28 (forthcoming fall 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2665820. Moreover, Professor Nagy disagrees with the *Newman* decision, going so far as to say, "The notion that courts should be interpreting Rule 10b-5 narrowly to facilitate an activity that is currently illegal is nothing short of absurd." *Id.* at 28–29.

The decision below comports with this Court's precedent and the congressional purpose undergirding Section 10(b). Although these reasons alone provide ample bases for affirming the decision below, recent research also indicates that strictly

proscribing insider trading is prudent from a socioeconomic perspective.

II. THE ECONOMIC BENEFITS OF STRICTLY PROSCRIBING INSIDER TRADING OUTWEIGH THE COSTS

Critics of the federal prohibition on insider trading argue that it should be permitted because insider trading promotes the efficient, or accurate, pricing of securities in capital markets.[3] But the United States is already home to some of the world's most efficient financial markets. At the same time, recent empirical studies indicate that insider trading has at least two adverse market effects. First, insider trading sometimes harms pricing efficiency due to a 'crowding-out' effect. Second, insider trading can incentivize managers to engage in earnings manipulation. Allowing insider trading to promote pricing efficiency therefore has costs that outweigh

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[3] Technically, "pricing efficiency" can refer to either informational or fundamental value efficiency, two related but distinct concepts: "A market is informationally efficient if investors cannot make abnormal returns by trading on public information ... a market is fundamentally efficient if prices accurately track the fundamental values of securities [*i.e.*, the true present value of expected future cash flows]." Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs*, 100 VA. L. REV. 313, 321 (2014).

any potential benefit, and undermines the integrity of our financial markets.

A. It Is Unnecessary To Allow Insider Trading To Promote Pricing Efficiency In United States Capital Markets

In his seminal work, *Insider Trading and the Stock Market* (1966), Dean Henry G. Manne posited that insider trading should be permitted because it brings relevant information to the market. *See Dirks,* 463 U.S. at 677 n.14 (1983) (Blackmun, J., dissenting) (citing Manne, *Stock Market, supra*, at 59–76, 111–146). *See also* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857 (1983) (predicting that pricing efficiency improves when trading by insiders with superior information quickly and accurately impounds information into stock prices). In 2005, Dean Manne published an article reasserting his claim that insider trading promotes market efficiency: "The argument for a strong positive relationship between market efficiency and insider trading has proved to be very robust." Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark*, 31 J. Corp. L. 167, 169 (2005). Although Dean Manne's position has been substantiated by some empirical research in recent years,[4] his statements warrant three qualifications.

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[4] *See, e.g.*, Ji-Chai Lin & Michael S. Rozeff, *The Speed of Adjustment of Prices to Private Information: Empirical Tests*, 18 J. FIN. RES. 143 (1995).

First, even Dean Manne recognized that the empirical support for his claim was mixed. Indeed, in the same passage as the above-quoted statement, he cited an empirical study that found no material difference between trading by informed insiders and uninformed outsiders on pricing efficiency. *See id.* at 169 n.11 (citing Sugato Chakravarty & John J. McConnell, *Does Insider Trading Really Move Stock Prices?*, 34 J. Fin. & Quantitative Analysis 191 (1999)). Second, there are various means by which financial markets quickly and accurately incorporate new information into stock prices. Indeed, Dean Manne acknowledged that "other mechanisms play a significant role in stock pricing, such as the explicit public disclosure of new information, sanctioned transmittal of information to financial analysts, and the so-called 'derivative' trading that occurs after some form of market 'signaling.'" Manne, *Hayek, supra*, at 169–70. *See also* Burton G. Malkiel, *A Random Walk Down Wall Street* 246 (9th ed. 2007) (identifying several factors, other than insider trading, that economists believe promote market efficiency). Third, it is questionable whether any increase in market efficiency from restricting the scope of the insider trading laws would be more than marginal. *See* George W Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 Del. J. Corp. L. 247, 250 (2013) ("Even in the absence of insider trading, the market for frequently traded securities is already quite efficient. Any benefit from the additional accuracy caused by insider trading would probably be trivial.")

B. Insider Trading Can Harm Pricing Efficiency Due To A Crowding-Out Effect

Other recent empirical studies, published after Dean Manne's 2005 article, cast doubt on the notion that insider trading consistently improves stock market pricing efficiency. For instance, an empirical study published in 2007 examined the relationship between countries' insider trading laws and certain measures of economic health. *See* Laura N. Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. Corp. L. 237 (2007). The author found that "countries with more stringent insider trading laws have more dispersed equity ownership; more liquid stock markets; and more informative stock prices." *Id.* at 240–41. These findings undermine Dean Manne's recent claim that "there is almost no disagreement that insider trading does always push the price of a stock in the correct direction [*i.e.*, toward a price that reflects the corporation's fundamental value]." Manne, *Hayek, supra*, at 169.

A 2009 study by two finance scholars investigated whether a country's first-time enforcement of its insider trading laws improved stock price informativeness (*i.e.*, accuracy). *See* Nuno Fernandes & Miguel A. Ferreira, *Insider Trading Laws and Stock Price Informativeness*, 22 Rev. Fin. Studs. 1845 (2009). With respect to developed economies, the authors observed a positive relationship between stock price informativeness and a country's initial enforcement of its insider trading laws. These findings

supported an earlier theory that predicted insider trading could lead to *less* efficient market pricing due to a 'crowding-out effect.' According to that theory:

> Insider trading crowds out information collection by outside investors by limiting the gains available to outside investors. Market professionals devote fewer resources to collecting information once they know there is a high probability of trading with insiders who have superior knowledge. If the crowding-out effect (deterring others from obtaining information) dominates, insider trading can actually make stock prices informationally less efficient.

Id. at 1845 (citation omitted).

In other words, barring insider trading protects securities analysts' incentive to seek out new information about firms, which can then be traded upon to improve pricing efficiency in capital markets. *Id.* at 1847–48.

To be sure, these studies do not disprove that insider trading can improve pricing efficiency in certain financial markets within certain economies. Nonetheless, these findings illuminate an important point: in developed economies, insider trading can harm pricing efficiency. In light of these foregoing studies, as well as the recent empirical evidence

discussed below, the market-efficiency rationale for permitting insider trading is unpersuasive.

C. Managers' Ability to Trade On Inside Information Can Incentivize Earnings Manipulation

An empirical study published last year identifies yet another potential adverse effect of insider trading. Professors Anup Agrawal and Tommy Cooper analyzed the prevalence of insider trading at more than five-hundred "publicly traded U.S. companies that announced earnings-decreasing restatements from January 1997 to June 2002 to correct misstated financial statements." *See* Anup Agrawal & Tommy Cooper, *Insider Trading Before Accounting Scandals*, 34 J. Corp. Fin. 169, 169–170 (2015). The authors measured the purchases, sales, and net sales of stock by corporate insiders before and during periods where companies' earnings were materially misstated. *Id.* at 170. In certain sample subgroups, the authors found strong evidence that top managers sell more stock during misstated periods when the subsequent earnings restatement caused large stock price declines. *Id.* at 171. These findings suggest that "top managers' desire to sell their stockholdings at inflated prices is a motive for earnings manipulation." *Id.* at 188. Accordingly, the authors view the Sarbanes-Oxley Act's prohibition on insider selling during misstated financial periods as a justifiable restraint on insider exploitation of insider information. *Id.*

III. A PECUNIARY-GAIN STANDARD WOULD JEOPARDIZE THE SEC'S RECENT PROGRESS IN DETECTING AND DETERRING INSIDER TRADING BY CREATING A LOOPHOLE IN THE INSIDER TRADING LAWS

Petitioner cites the increasing number of insider trading cases brought by the government over the last decade as evidence of a relentless drive to expand the boundaries of the insider trading laws. Pet'r's Br. 45–48. He seems to suggest that the government is engaged in an insider trading witch-hunt. However, recent empirical research points toward an alternative explanation: Despite aggressive government enforcement of Rule 10b-5, illegal insider trading is not only difficult to detect and prosecute, but it is also prevalent within the securities industry. Yet, there is also evidence that the SEC's aggressive enforcement efforts helped to deter insider trading from 2003 to 2011. Accordingly, it would be counterproductive to restrict the scope of the insider trading laws, especially in light of another recent empirical study indicating that the vast majority of criminal insider trading schemes involve tippers and tippees who share familial or social ties.

A. Despite Aggressive Government Enforcement Of Rule 10b-5 Over The Last Decade, Illegal Insider Trading Remains Prevalent And Difficult To Detect And Deter

Professor Bainbridge, a securities law professor at UCLA, has discussed the difficult task facing prosecutors when they bring an insider trading case: "It is often very difficult to tell when insider trading is taking place, and even when insider trading is suspected. Further, it is very difficult to identify the responsible party if many people had access to the information." Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. Rev. 1589, 1623 (1999). Professor Bainbridge argues that, due to its comparative advantage vis-à-vis private parties in terms of expertise, resources, and access to evidence, the SEC should assume the difficult role of monitoring insider trading. *Id.*

Prof. Bainbridge also stated that an earlier estimate that "one in five cases of insider trading is successfully prosecuted" was "probably too high by several orders of magnitude." *Id.* Notably, the problem seems to have persisted despite an increasing number of insider trading prosecutions: Three recent empirical studies find evidence that insider trading remains quite prevalent and has increased over the last two decades. *See* Laura N. Beny & H. Nejat Seyhun, *Has Insider Trading Become More Rampant in the United States? Evidence from Takeovers* (U. Mich. Law Sch. Scholarship Repository Working

Paper No. 50, 2012), http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1160&context=law_econ_current (analyzing data on pre-bid stock prices and call options in the context of corporate takeovers and finding evidence that illegal insider trading had increased between 1996 to 2011); Patrick Augustin et al., *Informed Options Trading Prior to M&A Announcements: Insider Trading?* (October 26, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2441606 (estimating that 25% of M&A announcements are preceded by illegal insider trading); Agrawal & Cooper, *supra*, at 188 (concluding that insider trading is more prevalent than previously documented in academic literature in light of evidence that insiders "boldly trade on a crime for which they are potentially liable.")

However, despite the difficulties with detection and prosecution, a study published in 2015 suggests that the SEC's aggressive enforcement efforts from 2003 to 2011 helped deter the frequency of illegal insider trading. Diane Del Guercio et al., *The Deterrence Effect of SEC Enforcement Intensity on Illegal Insider Trading: Evidence from Run-up before News Events* (October 5, 2015), http://ssrn.com/abstract=1784528. The authors found evidence that, as the SEC increased the amount of resources (*e.g.*, budget and staffing) it expended in prosecuting insider trading, anticipatory run-up in stock prices prior to news events (*e.g.*, earnings statements and takeover announcements)—which is

an academically recognized proxy for deterrence—declined. *Id.* at 4.

In light of the natural limitations imposed by the difficulty of detection and enforcement, it would make scant sense for this Court to restrict Rule 10b-5's scope, especially with respect to tipping liability.

B. New Evidence Indicates That Tippers And Tippees Frequently Share Familial Or Social Bonds

Petitioner has interpreted the Second Circuit's *Newman* decision to mean that familial or social ties, standing alone, are insufficient to satisfy the *Dirks* personal benefit test. Yet a recent study suggests that this Court should be worried about precisely these kinds of relationships if the government is to continue safeguarding our financial markets.

In a forthcoming article, finance professor Kenneth R. Ahern found that 93% of tippers were either family members, friends, or business associates with the tippees to whom they illegally provided information. Kenneth R. Ahern, *Information Networks: Evidence from Illegal Insider Trading Tips*, J. Fin. Econ. (forthcoming 2016) (manuscript at 3), http://ssrn.com/abstract=2511068. This statistic is based on Professor Ahern's analysis of 183 insider trading networks using hand-collected data from all of the insider trading cases filed by the SEC and the Department of Justice between 2009 and 2013. *Id.* at 2. The author found evidence that "many inside traders share a common educational background,"

such as attending college or high school together. *Id.* at 4.•

These findings are striking. The *Newman* court suggested that a common educational background should not suffice for purposes of the personal benefit test. Yet, Professor Ahern's research indicates that such social ties are often the building blocks for criminal insider trading schemes. To avoid creating a loophole that would allow a prevalent form of insider trading to escape criminal sanction, it is imperative that this Court affirm the decision below, which held that evidence of a familial or social relationship can satisfy the personal-benefit test. *See* Resp't's Br. 48–49.

CONCLUSION

Strictly proscribing insider trading is consistent with the Exchange Act and subsequent legislative enactments. Since *Dirks*, Congress has reaffirmed its view that insider trading should be deterred by both civil and criminal enforcement. Moreover, recent academic literature and empirical evidence indicate that insider tipping and trading can cause adverse economic effects and, further, that it is quite prevalent despite increased enforcement of Rule 10b-5. This Court should affirm the decision below to protect the integrity of the United States' financial markets.

Respectfully submitted,

SARAH M. SHALF
Counsel of Record
EMORY LAW SCHOOL
SUPREME COURT
ADVOCACY PROGRAM
1301 Clifton Road
Atlanta, GA 30322
(404) 712-4652
sarah.shalf@emory.edu

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